U.S. EQUAL EMPLOYMENT OPPORTUNITY COMMISSION
Washington, DC 20507

May 9, 2000

Office of
the Chairwoman

The Honorable James Jeffords
Chairman
Committee on Health, Education,
Labor and Pensions
United States Senate
Washington, D.C. 20510

Dear Chairman Jeffords:

The following is submitted to update you on certain issues related to employer conversions from traditional defined benefit pension plans to "cash balance" pension plans. I hope to continue these updates as the U.S. Equal Employment Opportunity Commission (Commission, EEOC, or agency) moves forward in its review of this complex issue.

As you know, the EEOC is currently studying a number of issues related to cash balance pension plans and is considering whether, or to what extent, these matters implicate the Age Discrimination in Employment Act of 1967 (ADEA). Clearly, these issues are, for several reasons, extremely complex and warrant careful consideration and study.

Since September, EEOC staff has met weekly with staff from the Department of the Treasury, the Internal Revenue Service, and the Department of Labor, to coordinate the enforcement of the ADEA, the Employee Retirement Income Security Act of 1974 (ERISA), and the Internal Revenue Code (IRC). It is our hope that the agencies can develop uniform policy positions that would assist employees and employers to understand their rights and responsibilities under the three statutes. The Internal Revenue Service published an advance notice of proposed rulemaking on October 20, 1999, and received several hundred responses from members of the public. The agencies have discussed the comments in detail and are analyzing the legal and policy arguments raised by the comments.

In addition, EEOC is reaching out to those in the private sector who have expertise in pension related issues, such as representatives of the American Society of Actuaries and Phyllis Borzi, of O'Donoghue and O'Donoghue. We have also met with knowledgeable representatives from the employer, labor, and civil rights communities, including the Chamber of Commerce, the Association of Private Pension and Welfare Plans (APPWP), Larry Lorber of Sonnenschein, Nath & Rosenthal, the American Society of Pension Actuaries, and the American Association of Retired Persons (AARP). We have found their views to be extremely useful in our analysis of the legal and policy implications of cash balance pension plans. Not surprisingly, however, the representatives of AARP, for example, on one hand and the employer community on the other, had very different views of the correct interpretation of existing law.

Finally, we have retained the services of an experienced actuary to help us analyze charges of discrimination that involve conversions to cash balance plans. As you may recall, in September the EEOC had received minimal charges in this area. However, since then charge receipts relating to cash balance plans now represent five percent of our ADEA charge receipts, amounting to over 650 charges. The actuary will assist EEOC in evaluating the actual effect of complex pension plan provisions on older workers. As we work with the actuary and analyze specific charges, we will be better equipped to answer more specific questions about the effect of cash balance plans and of conversions on workers of various ages and lengths of service.

Effect on Older Workers

Although our analysis at this stage is still incomplete, we can offer some preliminary observations about cash balance plans and conversions from career average or final average pay to cash balance plans. As you know, under career average or final average pay plans two employees with the same salary and service would have the same benefit at retirement, regardless of their ages.

In contrast, if cash balance plans are evaluated like most other defined benefit plans; *i.e.*, as an annuity at normal retirement age, the rate of accrual will typically decline as a direct result of age, until normal retirement age. This is because a contribution of, for example, $2000 in any given year, will buy a larger retirement benefit for a younger person. Thus, under a typical cash balance plan, if a thirty year old and a forty-five year old began and ended employment on the same day and made the same salary during their tenure, the one who began employment at age thirty would have a larger benefit at normal retirement age. Of course, cash balance plan proponents will point out that if those two employees took a lump sum when they departed, the amount of the benefit would be equal. Opponents will note that the lump sum would buy a larger annuity for the younger worker.

The accrual pattern in a typical cash balance plan is particularly detrimental to older, mid-career workers who are converted from a final average pay plan to a cash balance plan. Our preliminary analysis suggests that an employee who works for 30 years under a final average pay plan will earn fifty percent of his or her final benefit during the final ten to twelve years of employment. In contrast, under a cash balance plan, a thirty year employee would accrue fifty percent of his/her benefit during the first ten to twelve years of employment and only about twenty percent during the last ten to twelve years. Thus, unless the employer takes steps to ameliorate the effect, a mid-career employee who is subject to conversion gets the worst of each accrual pattern.

Legal Issues

The question before the Commission is whether the existing age discrimination law protects older workers affected by implementation of cash balance plans. The statute does not explicitly mention cash balance plans and, since few people had even heard of cash balance plans at the time, Congress almost certainly did not have such plans in mind when it enacted the Omnibus Budget Reconciliation Act of 1986. The fundamental issues are whether cash balance plans violate the ADEA by their very nature and, if not, whether conversions from traditional defined benefit to cash balance plans violate the Act.

Are cash balance plans inherently unlawful?

The first issue is whether cash balance plans, *ab initio*, violate section 4(i)(1)(A) of the ADEA, and its ERISA and IRC counterparts, 29 U.S.C. § 1054 and 26 U.S.C. § 411(b)(1)(h), which provide that the "rate of accrual" in a defined benefit plan may not decline because of age. Cash balance opponents assert that § 411(a)(7) of the IRC requires cash balance plans, like other defined benefit plans, to be assessed in terms of their value as annuities at normal retirement age. Using that measure, the accrued benefit in cash balance plans does decline with age in apparent violation of § 4(i)(1)(A) of the ADEA and its ERISA and IRC counterparts.

Cash balance plan proponents argue that opponents are using the wrong yardstick. They note that the statute does not define the term "rate of accrual" and contend that the account balance, *i.e.*, the present value, is the proper measure of the accrual rate. Using that measure, the rate of accrual is steady and does not vary with age. Proponents also note that the accrual pattern in cash balance plans is identical to the pattern in defined contribution plans and that defined contribution plans are explicitly legal under section 4(i)(1)(B) of the ADEA. They reason that an accrual pattern that is legal under section 4(i)(1)(B), should, as a policy matter, also be legal under section 4(i)(1)(A).

In addition, cash balance proponents point out that § 411(c)(3) of the Code allows any portion of a defined benefit plan that is attributable to employee contributions to be valued in the same way that cash balance plans are valued; *i.e.*, as a lump sum with interest that can be converted to an annuity. Opponents respond that § 411(c)(3) is a specific exception to the broader rule that the value at normal retirement age would control, and that the provision merely treats the portion of the retirement benefit attributable to employee contributions in essentially the same manner as if the employee had put the money in a savings account.

Do some conversions from traditional defined benefit to cash balance plans violate the ADEA?

If cash balance plans are not deemed to be inherently illegal, the question is whether converting from a traditional defined benefit plan to a cash balance plan is illegal. Some employers have taken steps to ameliorate this effect, such as "grandfathering" older, longer service employees and/or making additional contributions to such workers' benefits.

Absent such amelioration, cash balance plan opponents argue that the shift in accrual patterns described above, on page two, discriminates because of age in violation of the ADEA. Proponents argue that because defined contribution plans are legal under section 4(i)(1)(B), a conversion to a plan that mimics the accrual pattern of a defined contribution plan must be legal. Opponents counter that the statute distinguishes between defined benefit and defined contribution plans, imposing different requirements on them. The proponents' suggestion that what is legal under § 4(i)(1)(B) must also be legal under § 4(i)(1)(A) would nullify the statutory distinction between defined benefit and defined contribution plans. Opponents also allege that most conversions to cash balance plans involve overfunded pension plans and point out that an employer that converted from an overfunded defined benefit plan to a defined contribution plan would be subject to reversion penalties and that some conversions to cash balance plans are implemented to achieve the same end while avoiding the reversion penalties. That point, however, does not appear to be relevant to the age discrimination analysis.

Proponents of cash balance plans also assert that the harm to older workers is attributable to seniority rather than age and is, therefore, not unlawful. They recognize that the correlation between age and seniority could certainly give rise to a disparate impact claim but argue that disparate impact analysis should not apply under the ADEA. The Commission does apply disparate impact analysis to the ADEA but, of course, recognizes that the federal courts of appeals are split on the question.

Many conversions from traditional defined benefit plans to cash balance plans involve converting the benefit already accrued in the old plan into a "starting balance" in the cash balance plan. In some cases, the starting balance in the cash balance plan is lower than the value of the accrued benefits earned in the old defined benefit plan.

In such cases, an employee will earn no new benefits until the balance in the cash balance plan "catches up" with the value of the benefit already earned in the defined benefit plan. This "wear away" period usually falls more heavily upon older workers solely because of their age. Although proponents of cash balance plans argue that the wear away period is based upon length of service, in fact if two persons of equal years of service but different ages are compared, in almost all cases the older person will have the longer wear-away period.

The foregoing discussion illustrates the complexity of the legal issues and the extent of the disagreement about the meaning of the current law. EEOC remains committed to further explore the development of guidance or regulatory action in full coordination with IRS and DOL. It would be premature for the Commission to issue guidance at this point in time as we need to review a myriad of issues arising from the hundreds of charges recently received. As stated, these issues require a significant investment of resources, actuaries, reproduction costs, staffing, etc., which had not been anticipated during the normal budgetary process. Indeed, even if the agencies were to reach agreement about the proper interpretation of the statutory provisions at issue, that interpretation would be contested in court for years to come, leaving both employers and affected employees uncertain of their respective rights and obligations. In addition, several of the issues raised by conversions, such as avoiding reversion penalties, are presumably outside the scope of the age discrimination question.

We hope this information is helpful to you and would welcome an opportunity to discuss this issue with you in more detail. Staff from the Commission's Office of Communications and Legislative Affairs will contact your office to see if a mutually agreeable time to meet can be arranged. Should you have any questions or concerns, please feel free to contact Bill White at 202/663-4911.

Sincerely,

Ida L. Castro
Chairwoman